

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re JTS CORPORATION,
Debtor.

Case No. 98-59752 MM
Chapter 7

SUZANNE L. DECKER, Trustee,
Plaintiff,

Adversary No. 00-5424

v.

Opinion

ADVANTAGE FUND LTD., fka GFL
ADVANTAGE FUND LTD.; GENESEE
FUND LIMITED; NELSON PARTNERS;
OLYMPUS SECURITIES, LTD.; RGC
INTERNATIONAL INVESTORS, LDC; and
CAPITAL VENTURES INTERNATIONAL,

Defendants.

INTRODUCTION

This matter comes before the Court on the motion of Nelson Partners, Olympus Securities, Ltd. and Capital Ventures International to dismiss the complaint for failure to state a claim on which relief can be granted. Movants have alleged that because JTS did not convey property in which it had an interest, the Trustee cannot maintain a fraudulent transfer action. For the reasons stated below, the motion is granted.

BACKGROUND

JTS Corporation manufactured hard disk drives for notebook and desktop personal computers. In 1996 JTS merged with Atari Corporation. The merger was a vehicle for JTS to become a publicly traded company on the American Stock Exchange.

Shortly after the merger, JTS completed two private placements of convertible preferred stock. It first sold 15,000 shares of Series B Convertible Preferred Stock to Advantage Fund Ltd. and Genesee Fund Ltd. for \$1,000 per share, totalling \$15 million. A few months later, in January 1997, JTS sold 25,000 shares of Series C Convertible Preferred Stock to Nelson Partners, Olympus Securities, Ltd., RGC International Investors, LDC and Capital Ventures International for \$25 million.

Both the Series B and Series C preferred shares were convertible into shares of JTS common stock at a rate equal to the lower of either \$3.6125 per share or a floating conversion price equal to 85% of the average lowest trading price over the five-day period immediately preceding the conversion. The preferred shareholders were guaranteed either a price of \$3.6125 per share of common stock or a 15% discount off the market price. This means of raising capital is known as the placement of “floorless convertible” securities:

[S]mall, struggling public companies that cannot raise capital through traditional means have turned to a relatively new type of security, which, depending on one’s point of view, has been called a “floorless convertible,” “toxic convertible,” “death spiral convertible” or simply “junk equity.” . . .

Although the possible permutations are many, floorless convertibles typically take the form of privately placed preferred equity or debentures that are convertible to common stock after a fixed period of time. The conversion price is generally discounted 15% to 30% from the market price of the common stock at the time of conversion.

Robert C. Frieze and Jahan P. Raissi, Junk Equity Deals Can Harm Stock, 21 NAT’L L.J. B7 (February 15, 1999). The holder of the convertible security is protected against a declining stock price since “there is no maximum number of shares that can be received as the issuer’s market price decreases.” Joseph S. Allerhand and Timothy E. Hoeffner, New ‘Floorless Convertible’ Securities General Debate and Litigation, 220 N.Y.L.J. 1 (September 3, 1998).

JTS eventually issued over 64 million shares of common stock to the shareholders as they converted their preferred stock and exercised common stock purchase warrants. Between February 25, 1997 and

1 December 22, 1997, the defendants converted at least 38,650 shares of preferred Series B and Series C stock
2 to common stock.

3 During this time period, JTS incurred substantial losses. On February 23, 1998, JTS sold substantially
4 all of Atari's intangible assets for \$5,000,000 to a wholly owned subsidiary of Hasbro, Inc. JTS employed
5 approximately 5,500 individuals as of February 1, 1998, but during the remainder of that year JTS concentrated
6 on liquidating its assets and eventually laid off all but one employee.

7 An involuntary petition was filed against JTS on November 17, 1998, and JTS filed its own voluntary
8 petition for relief under Chapter 11 on December 4, 1998. On January 29, 1999, the Court ordered the case
9 converted to Chapter 7.

10 The Trustee brought two lawsuits arising out of JTS' attempts to raise capital in the years just preceding
11 the bankruptcy filing. The first is a suit against members of the Board of Directors and its professionals for
12 various breaches of their fiduciary duties, avoidance of fraudulent transfers, and negligence. The second action
13 is brought against the purchasers of the Series B and C stock. In this lawsuit, the Trustee alleges that the
14 conversions of preferred stock to common stock were fraudulent conveyances that should be avoided under
15 the Bankruptcy Code and the California Fraudulent Transfer Act. The Trustee seeks damages in the amount
16 of the difference between the discounted rate and the price at which the common stock was trading on the day
17 of each conversion, which she estimates at \$7 million.

18 CONTENTIONS OF THE PARTIES

19 Nelson Partners, Olympus Securities and Capital Ventures seek to dismiss the complaint on several
20 grounds. They first allege that the transfers of authorized but unissued common stock pursuant to the
21 conversions of preferred stock were not transfers of an interest in JTS' property and thus not vulnerable to
22 attack under the fraudulent transfer statutes. Additionally, movants assert that the claim under 11 U.S.C. § 548
23 cannot be sustained since nearly all conversions from preferred to common stock occurred more than one year
24 before the bankruptcy petition was filed. Finally, these defendants urge the Court to dismiss the claim for
25 intentional fraud on grounds that it was not pled with particularity.

26 The Trustee responds by arguing that because a corporation can own its unissued shares under
27 California law, those shares are the debtor's property. Since property of the estate is broadly defined, the
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1 authorized but unissued common stock was property in which JTS had an interest and thus subject to recovery
2 under fraudulent transfer law. As for the timing of the transfers, counsel stated at oral argument that the Trustee
3 would take discovery in order to determine when all potentially avoidable transfers occurred. Finally, although
4 the Trustee alleged intentional fraud in her complaint, she stated in her opposition to the motion to dismiss that
5 she will file an amended complaint dropping all allegations of intentional fraud. For this reason, the Court will
6 proceed as if the complaint alleged only constructive fraud.

7 LEGAL DISCUSSION

8 A. Standard for Motion to Dismiss

9 Pursuant to Federal Rule of Civil Procedure 12(b)(6), made applicable through Federal Rule of
10 Bankruptcy Procedure 7012, a complaint may be dismissed for failure to state a claim upon which relief can
11 be granted. A complaint should be dismissed only if “it appears beyond doubt that the plaintiff can prove no
12 set of facts in support of his claim which would entitle him to relief.” Conley v. Gibson, 355 U.S. 41, 45-46
13 (1957) (footnote omitted); see Cervantes v. City of San Diego, 5 F.3d 1273, 1274 (9th Cir. 1993). In
14 determining whether to grant a motion to dismiss, the court considers the allegations in the complaint and may
15 take judicial notice of matters of public record outside the complaint. See MGIC Indemnity Corp. v. Weisman,
16 803 F.2d 500, 504 (9th Cir. 1986). The court must assume that the plaintiff’s allegations are true and must
17 draw all reasonable inferences in the plaintiff’s favor. Usher v. City of Los Angeles, 828 F.2d 556, 561 (9th
18 Cir. 1987).

19 B. The Complaint Alleges Causes of Action Under 11 U.S.C. §§ 544(b) and 548

20 The statutory bases for the adversary proceeding are found in 11 U.S.C. §§ 544(b) and 548. “Section
21 544(b) of the Bankruptcy Code allows the trustee to avoid any transfers of a debtor’s property, which would
22 be avoidable under state law, and section 548 provides a federal statutory basis for avoiding fraudulent
23 transfers.” In re United Energy Corp., 102 B.R. 757, 760 (B.A.P. 9th Cir. 1989) (footnote omitted), aff’d,
24 944 F.2d 589 (9th Cir. 1991).

25 According to § 544(b), a trustee “may avoid any transfer of an interest of the debtor in property . . .
26 that is voidable under applicable law by a creditor holding an unsecured claim” The applicable law in this
27 case is California law. The particular provisions of California’s fraudulent transfer law state that:
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A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation as follows:

(b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(2) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

Similarly, § 548 of the Bankruptcy Code allows a trustee to

avoid any transfer of an interest of the debtor in property . . . that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily --

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

The Ninth Circuit has explained that "California's fraudulent conveyance statutes are similar in form and substance to the Code's fraudulent transfer provisions. Both allow a transfer to be avoided where 'the debtor did not receive a "reasonably equivalent value" in exchange for the transfer and [the debtor] was either insolvent at the time of the transfer or was engaged in business with unreasonably small capital.'" In re United Energy Corp., 944 F.2d 589, 594 (9th Cir. 1991) (quotation omitted).

C. The Policy Underlying the Fraudulent Transfer Statutes Requires the Court to Consider Whether a Particular Transfer Removed Assets From the Reach of Creditors

The Bankruptcy Code makes plain that "the policy behind section 548 is to preserve the assets of the estate." United Energy, 944 F.2d at 597. See U.S. v. Towers (In re Feiler), 230 B.R. 164, 169 (B.A.P. 9th Cir. 1999) ("The purpose of § 548 is to preserve assets of the bankruptcy estate for the benefit of creditors, and to prohibit 'the transfer of a debtor's property with either the intent or effect of placing the property beyond

1 the reach of its creditors.”) (citations omitted), aff’d, 218 F.3d 948 (9th Cir. 2000). Section 548 is “derived
2 in large part from section 67d of the Bankruptcy Act,” S. Rep. No. 95-989, 95th Cong. 2nd Sess. 89 (1978),
3 a section that focused on the “net effect of [a] transaction on the debtor’s estate” when determining whether
4 a transfer was for fair consideration. Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 992 (2nd Cir.
5 1981). In the spirit of its Bankruptcy Act predecessor, the reach of § 548 extends to transfers of assets that
6 would otherwise be available to creditors.

7 The effect of a transfer on creditors also is a factor when considering the California fraudulent transfer
8 statute. For example, in Maddox v. Robertson (In re Prejean), 994 F.2d 706 (9th Cir. 1993), the Circuit noted
9 that the California Fraudulent Transfer Act “requires ‘reasonably equivalent value’ to be determined from the
10 standpoint of the creditors.” Id. at 708 (citation omitted). According to the Legislative Committee Comment,
11 courts must consider the creditors’ viewpoint “in light of the purpose of the Act to protect a debtor’s estate from
12 being depleted to the prejudice of the debtor’s unsecured creditors.” Cal. Civ. Code § 3439.03 note 2 (West
13 2001). See also Cal. Civ. Code § 3439.01 note 2 (“[T]he purpose of this Act is primarily to protect unsecured
14 creditors against transfers and obligations injurious to their rights. . .”).

15 **D. Issuing Common Stock in Exchange for Convertible Preferred Stock Did Not Transfer an**
16 **Asset That Would Otherwise Have Been Available to Creditors**

17 The transfers in question were the conversions of preferred stock to common stock. The issue is
18 whether a corporation transfers an interest in property beyond the reach of creditors when it issues common
19 stock. The Bankruptcy Appellate Panel of the Ninth Circuit has held that it does not. Hansen v. Finn (In re
20 Curry and Sorensen, Inc.), 57 B.R. 824 (B.A.P. 9th Cir. 1986). In Curry and Sorensen, the BAP sustained
21 the bankruptcy court’s dismissal of an action to avoid the debtor’s transfer of shares of stock.

22 A share of capital stock represents a unit of ownership interest and has no extrinsic value to
23 the corporation itself. Since an action directed at recovery of corporate stock could only affect
equitable ownership of the corporation and would not restore property to the estate or avoid
an estate obligation, then it is not a transfer subject to question under Section 548.

24 57 B.R. at 829 (citations omitted). See also KDI Corporation v. Former Shareholders of Labtron of America,
25 536 F.2d 1146 (6th Cir. 1976) (issuing shares ten days before bankruptcy filing was not a preferential transfer
26 under the Bankruptcy Act because it did not affect the assets of the corporation).

1 In Curry and Sorensen, the debtor's president received 75,000 shares of stock in exchange for the
2 cancellation of two \$10,000 bonuses. The court did not reach the issue of reasonably equivalent value under
3 § 548 because the threshold requirement of a transfer of property of the debtor was not satisfied. This is the
4 only logical conclusion in light of the fundamental principle of corporate law that authorized but unissued stock
5 has no value to the issuing corporation itself.

6 Authorized but unissued stock is not an asset of the corporation. Intramerican Oil & Minerals, Inc. v.
7 Mid-America Petroleum, Inc. (In re Mid-America Petroleum, Inc.) 71 B.R. 140, 141 (Bankr. N.D. Tex. 1987)
8 (the debtor may issue shares of authorized stock without complying with the requirements of 11 U.S.C. § 363,
9 because that section applies only to sales of property) (citation omitted). In Mid-America Petroleum, the court
10 acknowledged one instance where a debtor might use its unissued stock – – as “part of a Plan of
11 Reorganization.” Id. In fact, the Bankruptcy Code contemplates that a debtor might issue securities “for cash,
12 for property, for existing securities, or in exchange for claims or interests, or for any other appropriate
13 purpose.” 11 U.S.C. § 1123(a)(5)(J). Significantly, § 1123(a)(5) separately classifies sales of property of the
14 estate and the issuance of securities as two independent means to fund a plan of reorganization. This distinction
15 emphasizes that unissued securities are not property of the estate but require a separate statutory instruction.
16 11 U.S.C. § 1123(a)(5)(D) and (J). See Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) (courts are cautioned
17 to avoid adopting “an interpretation of a congressional enactment which renders superfluous another portion
18 of that same law”) (citation omitted).

19 In our case, JTS transferred 40,000 shares of preferred stock to the defendants and received a \$40
20 million cash infusion. The Trustee does not attack that transfer, but instead seeks to avoid the conversion of
21 the preferred stock to common stock and to recover as damages any profits realized by the defendants from
22 the conversion. However, as in Curry and Sorensen, the Trustee is missing the threshold requirement of the
23 transfer of an interest of the debtor. Exchanging one form of equity ownership for another does not trigger a
24 fraudulent conveyance.

25 The Trustee has not alleged, and apparently cannot allege, that the sale of the Series B and C shares
26 was anything other than an arms' length transaction, negotiated in good faith. The defendants were allowed
27 to convert their shares at a discount because that was their agreement. The Trustee now seeks to deprive the
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1 defendants of the benefit of their bargain. She is not entitled to recover the discounted amount as the fruit of
2 a fraudulent transfer because that discount was neither an interest in property belonging to the debtor nor an
3 asset that would otherwise have been available to creditors.

4 **CONCLUSION**

5 In order to survive a motion to dismiss, the complaint must be capable of stating a claim that entitles
6 the plaintiff to relief. Since the issuance of common stock in exchange for preferred stock under a previously
7 negotiated agreement is not a transfer of property of the estate beyond the reach of creditors, it will not serve
8 the policy underlying §§ 544 and 548 to allow this action for avoidance of the transfers to go forward. Even
9 taking the Trustee's factual allegations as true, she can prove no set of facts that entitles her to relief because,
10 as a matter of law, there was no transfer of an asset that would otherwise be available to creditors. Without
11 such a transfer, there can be no fraudulent conveyance.

12
13
14 DATED: _____

UNITED STATES BANKRUPTCY JUDGE

Adversary No. 00-5424

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

CERTIFICATE OF SERVICE

I, the undersigned, a regularly appointed and qualified Clerk in the office of the Bankruptcy Judges of the United States Bankruptcy Court for the Northern District of California, San Jose, California hereby certify:

That I am familiar with the method by which items to be dispatched in official mail from the Clerk's Office of the United States Bankruptcy Court in San Jose, California processed on a daily basis: all such items are placed in a designated bin in the Clerk's office in a sealed envelope bearing the address of the addressee, from which they are collected at least daily, franked, and deposited in the United States Mail, postage pre-paid, by the staff of the Clerk's Office of the Court;

That, in the performance of my duties, on the date set forth below, I served the **Opinion** in the above case on each party listed below by depositing a copy of that document in a sealed envelope, addressed as set forth, in the designated collection bin for franking, and mailing:

Jeffrey C. Wurms
Wendel, Rosen, Black & Dean LLP
1111 Broadway, 24th Floor
Oakland, California 94607-4036

Harry S. Davis
Schulte Roth & Zabel LLP
919 Third Avenue
New York, New York 10022

Frederick D. Holden, Jr.
Brobeck, Phleger & Harrison LLP
One Market Plaza, Spear Street Tower
San Francisco, California 94105

Peter J. Benvenutti
Heller Ehrman White & McAuliffe
333 Bush Street
San Francisco, California 94104-2878

Gail Greenwood
Murphy Sheneman Julian & Rogers
101 California Street, Suite 3900
San Francisco, CA 94111

Leon G. Greenfield
Wilmer Cutler & Pickering
2445 M Street, N.W.
Washington, D.C. 20037-1420

Harvey L. Leiderman
Steefel, Levitt & Weiss
One Embarcadero Cetner, 30th Floor
San Francisco, CA 94111

Mark J. Hyland
Seward & Kissell
One Battery Park Plaza
New York, New York 10022

In addition, I am familiar with the Court's agreed procedure for service on the United States Trustee, by which a copy of any document to be served on that agency is left in a designated bin in the Office of the Clerk, which bin is collected on a daily basis by the United States Trustee's representative. In addition to placing the above envelopes in the distribution bin for mailing, I placed a copy of the **Opinion** in the United States Trustee's collection bin on the below date.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on:

Clerk